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SUBJECT: RUSSIA, SERBIA SIGN MOU ON PIPELINE

REF: A) Belgrade 404; B) Belgrade 1285

SUMMARY

1. (SBU) The Serbian Government (GOS), state-owned gas company Srbijagas and Russian Gazprom-Gazexport signed a Memorandum of Understanding (MOU) in Moscow on December 20 that establishes a framework for future cooperation and a possible agreement with Gazprom on extension of the Blue Stream gas pipeline from Turkey towards northern Italy. Just days before, Srbijagas had signed a new gas supply agreement for 2007 with Yugorosgaz, a shady Gazprom-linked company with its origin in the Milosevic era, instead of with Gazprom. The apparent link between the gas supply and the pipeline project demonstrates not only Gazprom's penchant for playing games, but also the readiness of the Kostunica government to play along with Russia. END SUMMARY.

MOU FINALLY SIGNED

2. (U) At a press conference on December 20, Prime Minister Vojislav Kostunica, Economy Minister Predrag Bubalo and Russian Ambassador Aleksandar Aleksejev announced that a Memorandum of Understanding (MOU) between the GOS, state-owned gas company Srbijagas and Russian Gazprom-Gazexport had just been signed in Moscow. This MOU, approved by the GOS on November 16, is a non-binding document that establishes a framework for future cooperation and a possible agreement with Gazprom on construction of a 400 km gas transit pipeline through Serbia worth approximately USD 1.3 billion (reftel B). However, Minister Bubalo said at the press conference that both sides are committed to implementing this important project.

3. (U) The gas transit pipeline through Serbia would extend the "Blue Stream" pipeline that feeds gas under the Black Sea to Turkey, through Bulgaria, Serbia, Croatia and onward to northern Italy. The construction cost in Serbia is estimated at USD 1.3 billion, and the total project, at some USD 15 billion. The total capacity of the pipeline would be some 20-25 billion cubic meters of gas annually, compared to Serbia's annual consumption of close to 3 billion cubic meters. Aside from Serbia, only Italy had signed an MOU with Gazprom. Press reports indicate that Bulgarian gas company Bulgargaz will soon sign a new agreement with Gazprom on increasing gas supplies from Russia and on usage of Bulgarian gas pipelines for transporting gas to the Western Balkan countries.

BENEFITS FOR SERBIA

4. (U) Bubalo said that the next step is to appoint experts from both sides to work out technical issues necessary for implementation; he predicted completion of the deal within six

months. He explained that the pipeline will follow the defined line of the future highway from Serbia to Bulgaria where the land has already been expropriated by the state. Construction should begin in autumn 2007 and be completed by 2010.

15. (U) Milutin Prodanovic, Assistant Minister for State-Owned Enterprises at the Ministry of Energy, explained that Serbia would receive significant benefits from Blue Stream. Serbia could receive EUR 200 million per year from transit revenues, depending on the specifics of the future agreement (reftel B). In addition, Serbia would have an alternative route for gas supply; now there is only one source, the pipeline carrying Russian gas through Ukraine and Hungary (reftel A). An alternative route, from Bulgaria (entering Serbia from Dimitrovgrad and heading to Nis) would provide Serbia with greater supply security. Prodanovic also explained that the 167-kilometer Nis-Dimitrovgrad gas pipeline, worth around USD 65 million, would become a starting point of the extended Blue Stream in Serbia (reftel A). Construction of Nis-Dimitrovgrad gas pipeline would enable further internal gasification of 400,000 households in Central and Southern Serbia.

CONDITIONALITY FROM GAZPROM SIDE

16. (U) When it comes to construction, Gazprom will manage its operations in Serbia through Yugorosgaz, says Milos Saramandic, former investment director at Srbijagas and now working in its financial department. Yugorosgaz was established as a joint venture between Gazprom and various Serbian companies back in 1996 to manage the distribution of Russian gas and investment in gas infrastructure in Serbia based on two intergovernmental agreements between Russia and Serbia from the 1990's (reftel A). Just days before the pipeline MOU was signed in Moscow, Srbijagas on December 18 signed a new annual agreement for 2007 gas deliveries with Yugorosgaz as a representative of Gazprom. Srbijagas sources told us that Gazprom required that Srbijagas sign the 2007 gas supply agreement with Yugorosgaz, instead of Gazprom.

17. Laza Djurdjevic, Assistant to the Executive Director for Technical Operations said that the current price that Srbijagas is paying to Gazprom is USD 260 per 1,000 cubic meters of gas and it should stay the same since the price of gas is not defined by the new agreement but is counted according to the specific methodology. In addition, Srbijagas is paying USD 25 per 1,000 cubic meters to Hungarian gas company MOL as a transit tax. The deal with Yugorosgaz as a mediator will increase the total cost to Srbijagas, said Saramandic. Furthermore, Saramandic said that the stability of gas supply is at risk since Yugorosgaz has not provided any bank guarantees for this business worth millions of dollars.

17. (SBU) These agreements from the Milosevic era have never been confirmed nor rejected by successive democratic governments since 2000, and the status of Yugorosgaz is undefined. Some claim that these contracts give the Russians exclusive rights to build gas pipelines in Serbia, although some GOS officials have told us that the old agreements only permit Yugorosgaz to bid equally with other bidders in public tenders for any potential projects (reftel A). Srbijagas deals gingerly with this issue because of its dependence on Russian gas and its huge debt of approximately USD 235 million to Gazprom. However, due to the agreement that Serbian Minister of Economy Predrag Bubalo and Russian Minister of Emergency Situations Sergei Shoigu initialed on December 13 in Moscow, part of the Serbian gas debt in the value of USD 188 million will be settled through the clearing debt of the former USSR toward Serbia. The total value of the clearing debt is USD 288 million. The rest of USD 100 million will be used for the general overhaul of the Djerdap hydroelectric power plant. The amount Serbia is entitled to in the form of interest will be used for the construction of an accelerator at the Vinca Nuclear Institute.

18. (SBU) Zorana Milanovic Mihajlovic, formerly energy adviser to ex-Deputy Prime Minister Labus, said that by signing this new agreement for gas deliveries with Yugorosgaz, the GOS indirectly accepted the Milosevic era agreements and the exclusive right of Yugorosgaz to build gas pipelines and supply Srbijagas with Russian gas without any public tenders or transparency. Saramandic confirmed that Yugorosgaz has a license for building gas pipelines and just recently received a gas trading license like Srbijagas.

YUGOROSGAZ: ANOTHER SHADOWY GAZPROM ASSOCIATE

¶9. (SBU) Yugorosgaz has a twisted history in Serbia. Saramandic said that, when established, its ownership was split 50:50 between Gazprom and Serbian companies - state-owned oil company NIS, the Sartid steel mill, foreign trade company Progres-Beograd, Progres Gas Trading and Beobanka. It was agreed that NIS would have priority purchasing rights and over time would become the majority owner of Yugorosgaz. It is unclear why NIS did not use that option.

Another Gazprom associate, Austrian Centrex working through its subsidiary, Turkey-based Bosphorus Gaz, bought the shares of Progres Gas Trading and left Srbijagas with only 25 percent in Yugorosgaz, explained both Saramandic and Milanovic Mihajlovic. (The owner of Centrex is said to be Alexandar Medvedev, executive director of Gazprom-Gazexport.)

¶10. (SBU) Saramandic explained that Progres Gas Trading was a joint venture company between Gazprom and Progres (linked to Milosevic cronies) to import gas from Russia during the period of sanctions, before Yugorosgaz was established. He alleges that Progres Gas Trading was used as a conduit for money laundering. The management of former Progres Gas Trading which is still active in Yugorosgaz today helped Gazprom to buy 25 percent of Progres Gas Trading in Yugorosgaz and become the majority owner in it.

NEGOTIATION WITHOUT EXPERT OPINION

¶11. (SBU) Saramandic said that the idea for extension of the Blue Stream though Serbia originated with Srbijagas and was first proposed by Serbian President Boris Tadic to Russian President Putin. Putin accepted the idea and Kostunica appointed Bubalo and Minister of Finance Mladjan Dinkic to negotiate with the Russians. However, Srbijagas then was sidelined in the discussions. For instance, Saramandic confirmed that the new director of Srbijagas did not see the final version of the MOU before it was adopted.

¶12. Saramandic asserted that Bubalo and Dinkic did not get much from Gazprom in return for entering the Serbian market. They managed to include the Serbian debt to Kuwait assumed by Gazprombank that would be settled through the Serbian allocated portion of the transit fee but they did not receive commitments to lower gas prices or percentages of Serbian company participation in gas pipeline construction. These details were left for the working groups, which takes a longer period of time and further compromises. Saramandic said the Serbian side was told implicitly that the signing of the 2007 gas delivery agreement would be a condition for the signing of the MOU.

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